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Reopening Public Comment Period and Establishing Workshops on Proposed Rule--Establishing Oil Value for Royalty Due on Federal Leases; 64 FR 12267 (March 12, 1999)

Dear Sir:

Chevron U.S.A. Production Company, a Division of Chevron U.S.A. Inc. ("Chevron"), appreciates the opportunity to comment further on the subject proposed rule. As one of the largest lessee/payors of royalties on oil produced from federal leases, Chevron is significantly affected by the proposal.

Chevron endorses and incorporates by reference the joint comments of the American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council, and the United States Oil and Gas Association, as well as the Industry Proposal submitted in the MMS public workshops in Houston (March 23, 1998), Albuquerque (March 24), and Washington, DC (April 6-7, 1999). Chevron also incorporates by reference and reiterates herein all its prior comments.

I. Preferred Alternative to the Proposed Rule

Again, Chevron encourages MMS to do the right thing for the American people by taking the federal royalty in kind. In so doing, the value of production would be established at the time of production by means of an agreed upon sale price, rather than many years later, as in the case of royalty paid in value. Payment of royalty in value to the government has become the equivalent of writing America a blank check, with the amount not determined until years later, after costly and unnecessary audits, administrative appeals, and litigation. This is because the Department's interpretation of its valuation regulations and verification of royalty payments invariably does not occur until many years after the royalties have been paid. Lessees, on the other hand, must interpret the valuation rules and calculate and pay royalty by the end of the month following production. It is no wonder that disputes arise. By way of example, what lessee could have foreseen when making royalty payments on natural gas liquids ("NGL") how the Department would eventually interpret its NGL valuation regulations in the infamous "Procedure Paper"? And who could have known when the 1988 valuation rules were adopted that the Department would, many years later, adopt the position that ANS spot prices should have been used to calculate royalty value on oil produced from federal leases in California rather than posted prices? MMS' latest proposal will fail to fix the inherent problems that have arisen from requiring royalty payments in value, because it perpetuates complicated and ambiguous valuation rules and fails to break the recurring cycle of uncertainty.

A comprehensive royalty-in-kind program would allow the government to eliminate cadres of federal employees required to verify and ascertain correct royalty value. It would allow the government to participate in downstream markets, with the expectation of achieving higher revenues, without imposing on federal lessees an obligation to market production downstream rather than at the lease. Finally, a comprehensive royalty-in-kind program would achieve what all Americans, from federal lessees to the school children supported by federal royalty dollars, have the right to know, namely, the fair value of production from federal lands at the time of severance.

II. How to Fix MMS' Proposed Rule

For the reasons set forth in prior comments, Chevron continues to believe that the proposed rule in seriously flawed and cannot succeed in its present form. If the Department of Interior is intent on being paid in value, then Chevron urges that the final rule reflect the Industry Proposal set forth in the workshops and in the joint comments of API, IPAA, DPC and USOGA. In addition, Chevron would like to emphasize some areas of concern.

Opposing Economic Interests

The "opposing economic interests" language contained in the definition of arm's-length contract is far too vague, uncertain, and subjective. It will most likely result in future royalty disputes. For example, earlier versions of the proposed rule contained specific limitations on the use of a lessee's arm's-length sales price in determining royalty value, e.g., where the lessee and its purchaser in one transaction are also involved in any other transactions. In response to prior comments, MMS removed those earlier restrictions on the use of arm's-length proceeds. Having removed such restrictions, it would be extremely unfair of MMS to maintain that all arm's-length contracts between parties who entered other transactions with each other failed to meet the opposing economic interests requirement. Chevron recommends that the opposing economic interests requirement be removed. Alternatively, if it is not removed, then the rule should set forth specific criteria required for demonstrating lack of opposing economic interests. MMS, not the lessee, should bear the burden of proof.

<u>Index Option for Arm's-Length Sales</u>

Chevron joins industry in urging that lessees who engage in arm's-length transactions be given the option to value those dispositions based on an index methodology. The latest proposal allows a lessee with an affiliate the option to trace downstream proceeds or to use the index methodology. However, many lessees, both integrated and independent, do not sell their oil production to affiliates. However, these lessees may engage in numerous different types of dispositions (e.g., outright sales to third parties, buy/sell or exchange agreements, transfers to a refinery) that require different treatment under the proposed rules and may require theoretical tracing of production far downstream.

For example, assume a lessee owns 50 leases in the Gulf of Mexico and that production from all 50 leases (50,000 Bbl) is shipped directly to Empire Terminal. Assume that the lessee also purchases 10,000 Bbl at various locations and ships it to Empire. Of its 60,000 equity barrels at Empire, the lessee then ships 5,000 Bbl to a refinery, re-positions 25,000 Bbl to other market centers by means of 5 separate exchange agreements, sells 15,000 Bbl by means of 3 separate outright term sales, and sells the remaining 15,000 Bbl by means of 15 separate outright spot sales. Assume that none of the dispositions at Empire specify source leases. In order to comply with the proposed rule, theoretical tracing would be required. The lessee would first determine the portion of Empire dispositions to be valued based on proceeds vs. the index methodology . The 30,000 Bbl sold in arm's-length term and spot sales prices would be valued based on a weighted-average price. The 5,000 Bbl of refined production would be valued based on the index methodology. For the 25,000 Bbl disposed of in buy/sell agreements, the lessee would have to choose between tracing the production further downstream (where any combination of other dispositions could occur) or using the index methodology. Assume the lessee chose to value the 25,000 exchanged Bbl based on index. The lessee would be required to theoretically trace all dispositions at Empire back to each of the 50 leases: 50% of production from each lease would be valued based on the weighted-average arm's-length sales price at Empire, and the remaining 50% would be valued based on the index methodology. Transportation and quality adjustments would be calculated for each of 50 leases for both the arm's-length sales and the index method. Then, subsequent adjustments to any of the 18 separate outright sales <u>or</u> to the portion of Empire dispositions to be valued based on downstream proceeds vs. index (e.g., 30,100 Bbl sold outright and 29,900 Bbl refined or traded, rather than 30,000 Bbl sold outright and 30,000 refined or traded) would necessitate that royalty for all 50 leases be recalculated and re-reported. Then, upon audit, if MMS determined that one or more of the 18 outright sales lacked "opposing economic interests", the lessee may be required to recalculate and re-report royalty for all 50 leases.

Chevron suggests that lessees wishing to avoid downstream tracing and retroactive adjustments and the uncertainty and risk of arm's-length contracts being deemed to lack opposing economic interests should be given the option to use the index methodology to value their arm's-length sales.

III. Conclusion

Chevron again urges MMS not to publish the proposed rule as a final rule, but rather to take all its royalty in kind. Alternatively, Chevron urges MMS to adopt the Industry Proposal, as explained in industry comments.

Respectfully submitted,

George W. Butler III by e-mail

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